2.02 Revenue Recognition Step 2

2. Identify Separate Performance Obligations

A contract will have at least one, and often more than one, **performance obligation**, which is an enforceable promise to transfer goods/services to a customer. The goods/services may be either:

- A single good/service or a bundle of goods/services; or
- A series of distinct goods/services that are substantially the same with the same pattern of transfer (eg, monthly cleaning service).

Performance obligations are identified at the inception of the contract. They may be explicitly stated in the contract or may be implicit due to the entity's business practices. For example, the customer expects a car wash with her oil change because the dealership customarily provides such service along with oil changes.

Performance obligations are identified at the inception of the contract. Examples include:

- Selling goods produced or purchased by the entity
- Reselling rights to goods/services that were purchased by the entity
- Performing a task that is agreed upon
- Being prepared to provide a good/service or making goods/services available to the customer with transfer at the customer's discretion
- Arranging for another party to provide goods/services to a customer
- Providing the rights to future goods/services to a customer who may, in turn, resell or otherwise provide them to their customers
- Creating an asset on behalf of a customer
- Granting licenses
- Granting options to purchase additional goods/services

An activity that does not result in the transfer of goods/services to a customer is **not** a performance obligation.

Individual performance obligations are either identified as distinct performance obligations or are combined with other performance obligations until such combination constitutes a distinct performance obligation. **Distinct performance obligations** are those that meet *two criteria:*

- The customer must be able to **benefit from the good or service on its own** or together using other resources that are readily available to the customer; and
- The promise to transfer the good or service is **separately identified from other promises** in the contract.

A good or service can be *used on its own* if it can be consumed, sold for more than scrap, or used for economic benefit. Resources are readily available if they are sold separately, by the same seller or others, or if the customer has previously acquired them. For example:

- If a furniture dealer was selling a kitchen table and a living room sofa to a customer, the kitchen table could be used without the sofa and vice versa. Thus, they would each represent a distinct performance obligation.

- If the two items were a unique tabletop and a base that was designed exclusively for that tabletop, neither the tabletop nor the base could be used without the other. Thus, neither would be a distinct performance obligation but, on a combined basis, they make up a single distinct performance obligation.
- If the tabletop was a standard size and the customer could acquire a base from a variety of vendors, the tabletop and the base would each be a distinct performance obligation.

Promises are *separately identifiable* in a contract if goods/services are promised separately as opposed to promising to deliver goods/services on a combined basis, with promised goods/services being used as inputs. For example:

- Promises may be made to deliver a computer and an operating system.
    - The intent may be to use the operating system in the computer.
    - Since an operating system could be acquired from a different vendor and installed into the computer, and the operating system could be installed in a computer purchased from a different vendor, the computer and the operating system are separately identifiable and would be distinct performance obligations.
- A promise may be made to deliver a computer with an operating system installed.
    - Since the contract combines the computer and the operating system into a single promise, the promises are not separately identifiable.
    - Even though the operating system could be used with another computer and the computer with another operating system, since they are not separately identifiable, they are not distinct performance obligations.

Other factors may indicate that promises are separately identifiable:

- The entity does not need to integrate the goods/services with others that are part of the contract.
- Other goods/services are not significantly modified by the good or service in the contract.
- Goods/services are neither highly dependent on, nor highly interrelated to, other goods/services in the contract.

When goods/services are not material, it is not necessary to determine if they constitute performance obligations. In addition, an entity may elect to consider shipping and handling costs that are incurred after the control of goods has been transferred as a cost of fulfilling a promise, rather than as a separate promise.

Warranties

Warranties can be accounted for in a variety of ways and the circumstances surrounding the warranty will determine which accounting approach is most appropriate.

Warranties may be *purchased separately*. This will often be true when the customer is purchasing an item that has no warranty, a limited warranty with significant gaps in coverage, a warranty that ends too quickly, or some combination.

- The price of the warranty is generally either established or negotiated separately.
- The warranty is a distinct performance obligation.

Some products *provide warranties* without requiring an additional or separate payment. The cost of the warranty is included in the purchase price of the goods to which the warranty relates. Some of these warranties are *assurance-type* warranties, while others are *service-type* warranties.

An **assurance-type warranty** protects the customer from obtaining a product that is not capable of performing at the level that the seller indicated that it would. These warranties are generally only available from the seller. To the seller, such a warranty is a contingent liability.

- A liability will be incurred if the product does not perform.
- Unless this is a unique product to the seller, the seller should be able to estimate:
    - The frequency with which these products will not perform at an acceptable level; and
    - The average cost incurred to repair or replace the product when it does not perform acceptably.
- It is very likely that there will be some units that will not perform acceptably.
    - Even entities with outstanding internal control experience some human error.
    - In addition, some units are bound to have parts fail or other problems.
- As a result, an assurance-type warranty represents a **contingent liability** that is **probable and estimable** and should be accrued in the period incurred, generally the period of sale.

A **service-type warranty** generally provides a customer with repairs in the form of parts and labor in addition to making certain that the product performs as promised. Service-type warranties may be required by law, may extend beyond the reasonable amount of time it should take to evaluate the product's performance, or may provide services that extend beyond making certain that the asset performs as expected.

- A service-type warranty is a separately identifiable promise in a contract; and
- It is a distinct performance obligation.

To illustrate an *assurance-type warranty*, assume a company sells drilling equipment at an average sales price of $40,000, which it acquires at a cost of $25,000. The seller provides a warranty to assure the buyer that the drill will perform to a certain standard and be suitable for drilling through certain types of materials.

- The company has been manufacturing these drills for several years and they are confident in their manufacturing process, the quality of the materials used, and the quality of its labor force.
- Despite that, human error, the occasional faulty material, or some other factor causes 1 out of every 100 units to fail and require replacement.
- At a cost of $25,000 per drill, a loss of 1 out of every 100 will cost the company $250 per drill on average.

The sale of a single drill will be recorded as follows:

Cash (or A/R)	40,000	
Sales Revenue		40,000
Cost of sales	25,000	
Inventory		25,000
Warranty expense	250	
Estimated warranty liability		250

To illustrate a *service-type warranty*, assume a company sells washing machines to the public. To stimulate sales, the company provides a three-year warranty that basically will repair the machine, regardless of the cause of the malfunction, for a period of three years.

- The washing machine has a sales price, including the warranty, of $1,200. Although the company does not sell their machines without the warranty, an appliance store within a mile of the company's store does sell the same washing machine for $950 on an "as-is" basis.
- The washing machine costs the company $600.
- The company does sell 3-year service contracts, comparable to the warranties, to owners of washing machines purchased from other dealers at a sales price of $250.
    - The company estimates that it costs approximately $175 to service the warranty.
    - Both the washing machine without the warranty and the warranty are distinct performance obligations.

Since both the washing machine and the service-type warranty are distinct performance obligations, the revenue of $1,200 will be allocated based on their relative standalone prices. The revenue allocated to the washing machine will be recognized upon satisfaction of the performance obligation (ie, the point of sale). The revenue allocated to the warranty will be recognized while the performance obligation is being satisfied over the three-year term.

Cash (or A/R)	1,200	
Sales		950
Deferred revenue – warranty		250
Cost of sales	600	
Inventory		600

Option to Purchase Additional Goods or Services

In some cases, a contract with a customer may include an option to purchase additional goods or services at a discount. That discount may be comparable to a discount that is available to a wide range of individuals, including customers and noncustomers alike. This would *not* be considered a distinct performance obligation since customers who receive the discount when making the purchase are not getting anything of value that is not available to others who make no purchase.

When a discount of this sort exceeds what is available to noncustomers, the customer is receiving something of value (ie, a material right); thus, both the goods sold and the discount represent *distinct performance obligations*. Therefore, the gross sales price will be allocated between the sale of the merchandise in the current period and the discount on future purchases.

- **The value of the merchandise** will be equal to what it would be sold for if there was no discount on future purchases or any other benefits.
- **The value of the future discounts** will be based on an estimate of the discounts expected to be applied. The estimate will be adjusted to its present value since at least a portion of the discounts will be applied in future periods.

Revenue allocated to the sale of goods will be recognized upon satisfaction of the performance obligation, at the point of sale. Revenue allocated to the future will be recognized while the

performance obligation is being satisfied in the pattern in which the discounts are estimated to be taken, or when it expires if it's a discount voucher, for example.

As part of a contract for the sale of a Product for $100, the entity gives the customer a 40% discount voucher for future purchases up to $100 that is good for 30 days. The entity is also offering a 10% discount to all customers for the next 30 days. The 10% discount is not combinable with the 40% discount voucher. Since all customers will receive a 10% discount during the next 30 days, only the additional 30% discount constitutes a separate performance obligation.

The entity estimates that there is 80% chance that a customer will redeem the voucher and will, on average, purchase $50 of additional products. The standalone selling prices and the resulting allocation of the $100 transaction price are calculated as follows:

Performance Obligation	Standalone Selling Price	
Product	$100	
Discount voucher	12	($50 avg. × 30% disc. × 80% probability)
Total	$112	

Performance Obligation	Allocated Transaction Price	
Product	$89	Recognize when control transfers (100/112 × 100)
Discount voucher	11	Recognize when redeemed/expired (12/112 × 100)
Total	$100	

	Debit	Credit
Cash	100	
Revenue		89
Deferred Revenue		11

(ASC 606, Example 49)

Nonrefundable Prepayments

Generally, when prepayments are received (eg, customer buys a gift card), the entity should record a contract liability for the customer's unexercised rights to goods/services. However, when those prepayments are nonrefundable, they may be taken into income to the extent the rights created by those payments are not expected to be redeemed by the customer (aka, breakage). Such payments are recognized:

- As revenue in proportion to the pattern of rights exercised by customers if **breakage is expected.**
- As revenue when the likelihood that the customer will exercise the rights becomes remote if **breakage is not expected.**
- **As a liability** when the amounts are required to be remitted to a third party (eg, a government agency due to unclaimed property laws).

Assume $1,000 of gift cards were sold in Year 1 and the entity expects only 80% ($800) to be redeemed. Since the entity expects 20% breakage, it will recognize revenue for the breakage as the gift cards are redeemed:

	Redeemed	+ Breakage	= Revenue Recognized
Year 1	$600	600/800 × 200 = 150	750
Year 2	$200	200/800 × 200 = 50	250
Total	$800	$200	1,000

If, however, the entity expected all the gift cards to be redeemed, they would wait to recognize the revenue on unredeemed gift cards until there is only a remote possibility of redemption.